PINE ADVISOR SOLUTIONS www.pineadvisorsolutions.com

Quarterly Newsletter

Q2 Brain Teaser Question 💡

How many times per day do the hands on a clock overlap?

Answer at the end!

In This Issue

With the arrival of warmer weather in Q2, the PINE team resumed their tradition of after-work kickball games.

I. Vacating the Private Funds Rule - the 5th Circuits Decision Regarding Stricter Private Fund Regulation

On June 5, 2024, the United States Fifth Circuit Court of Appeals in New Orleans sided with the private funds industry, determining that the Securities and Exchange Commission ("SEC") did not have statutory authority to formulate the Private Fund Advisers Rule.

The Court noted in its unanimous decision to vacate the 2023 finalized rulemaking that the agency overstepped its authority in adopting the rule. This decision negates the pending estimated cost of $5.4 billion and millions of hours of employee time dedicated to the new compliance requirements.

What was the rulemaking overturned by the Court?

The SEC adopted the rule in August of 2023 with the intention to enhance the regulation of private fund advisers in an effort to protect individuals who invest in private funds. Private funds are, as their namesake eludes, private, and only open to some of the most sophisticated and wealthiest investors, unlike their registered pooled investment vehicle counterparts.

Historically, this distinction has allowed private funds and their advisers to avoid the extensive regulation under the Investment Company Act of 1940 ("ICA") that mutual funds and other registered pooled investment vehicles are subject to. The ICA, and later on the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act"), purposefully exempted private funds from much of the prescriptive pooled investment vehicle compliance framework, permitting private funds to freely negotiate fund agreements, advisory fees, and other terms.

The SEC and opponents of the Court's decision felt there was a need to enhance the regulation of private fund advisers to protect investors stemming from a lack of transparency, conflicts of interest, and lack of governance mechanisms in the private fund sector.

Under the previously finalized (and no defunct) reforms, the SEC intended to implement 5 main rules into the private fund industry: (1) the preferential treatment rule, (2) the restricted activities rule, (3) the quarterly statements rule, (4) the adviser-led secondaries rule, and (5) the audit-requirement rule. Additionally, the reforms amended previous rulemaking addressing annual compliance documentation and recordkeeping.

What was the basis for the Court's decision?

Critical to the Court's decision was the distinction between retail investors and those investing in private funds subject to qualification standards. Detrimental to the SEC's argument for upholding the rules, the Court noted that the SEC heavily relied on securities laws provisions applicable only to retail investors and not to private fund investors.

With their intention to categorize private fund investors in the same group as retail investors, the SEC sought to impose a heightened duty of disclosure on private fund investment advisors in the name of "protecting investors". The Court disagreed with this position as the ICA and Congress specifically carved out private fund investors from the respective provisions of the ICA.

The "pervasive fraud" the SEC was intending to cure with the rulemaking was not rationally related to any part of the final rule the SEC adopted. As the decision pointed out, the SEC conflated a lack of disclosure with fraudulent advisory practices, but a failure to disclose cannot be deceptive without a duty to disclose.

What is next for Private Fund regulation?

It is currently unknown how the SEC intends to proceed with their now-vacated rulemaking in the court system, although an appeal is anticipated. For many in the industry, this court decision appears to signal a significant change in projected outlook of the SEC regulatory landscape for the near future, given the agency's recent stance on regulating the private funds industry and the now curbing of such authority by the courts.

PINE will continue to monitor for updates to the SEC's evolving rulemaking agenda

and what the court's decision means next for private fund investment advisers. If you have any questions, please feel free to reach out to PINE for more information.

II. Tailored Shareholder Reports: Key Considerations

On October 26, 2022, the SEC adopted a rule and formed amendments that require open-end funds, including ETFs, to provide annual and semi-annual "tailored" summary shareholder reports to all shareholders.

The rule amendments aim to enhance the transparency and accessibility of shareholder reports and disclosures while focusing on key information relevant to shareholders.

The SEC's amendments were effective January 24, 2023, with a July 24, 2024, compliance date.

Crucial Takeaways

The amendments exclude open-end funds from Rule 30e-3 under the Investment Company Act of 1940, as amended, which permitted certain registered investment companies to satisfy report transmissions by making the reports available electronically to shareholders with notice of online availability.

Open-end shareholders will receive the new tailored annual and semi-annual shareholder reports directly, with an option to elect to receive them electronically. The full shareholder reports must also be made publicly available on the fund's website. Web hosting requirements will be more comprehensive. For instance, online disclosures need to be easy to read and print, with links between documents.

Each fund, and share class within, will be required to have its own report, allowing shareholders to distinguish different types of information for each series. This requirement will result in more content review and additional work for administrators and distributors.

The new tailored reports will be significantly shorter than current shareholder reports, transitioning certain information to the Form N-CSR instead, including the complete schedule of investments and full financial statements.

The shorter tailored shareholder reports will be 3-4 pages long and must include summary information on expenses, performance, holdings, key statistics, material changes, and other summary information.

Language should be straightforward, in "plain English," ensuring shareholders can grasp key information that is pertinent to them.

In addition, the SEC amended the definition of a broad-based index as referenced in shareholder reports and prospectuses, to compare fund performance to that of an index that reasonably represents the overall applicable securities market.

Design Techniques

The content, format, and presentation of the tailored shareholder reports are governed by new Item 27A of Form N-1A. New Item 27A permits or requires funds to utilize design techniques that facilitate effective communication, such as charts,

graphs, bullet lists, and graphics.

Additionally, new Item 27A promotes the use of online tools and electronic media to further a shareholder's understanding of the information, such as hyperlinked video or audio, pop-up boxes, chat functionality, and expense calculators.

Fund Performance

In the existing framework within the narrative disclosure section of the report, funds are mandated to thoroughly delve into the factors significantly impacting the fund's performance.

With the new regulation in place, funds will be tasked with providing a concise yet comprehensive summary, offering a high-level overview of the key factors materially influencing the fund's performance.

While the amendments to the rule may pose some compliance and operational hurdles for funds and their service providers, they also offer opportunities to thoroughly reconsider and refresh investor communications. The amendments aim to enhance shareholder engagement and improve the investment experience.

Reach out to PINE to see if this will impact you.

III. Key Steps for Managing Electronic Communications in 2024

In December of 2018, the Securities and Exchange Commission ("SEC") released a Risk Alert pertaining to Observations from Investment Advisor Examinations Relating to Electronic Messaging.

At the time that this Risk Alert was released, what was then the SEC's Office of Compliance Inspections and Examinations ("OCIE") found that investment adviser personnel had access to a growing array of tools for business-related communications.

It is now mid-2024, OCIE has been rebranded to the Division of Examinations, and their focus on the risks pertaining to use of electronic communications has only increased. As the SEC continues to ramp up its focus on electronic communications, the below steps may help increase your confidence in your firm's electronic communications practices.

Understand the regulations and requirements associated with electronic communications

Generally speaking, under Rule 204-2 of the Investment Advisers Act of 1940 (the "Books and Records Rule"), investments advisers must retain all business-related written communications received and sent for a period of five years.

Understand what constitutes business-related communications requiring preservation under the Books and Records Rule

Advisers may find this difficult to navigate because the SEC has not offered a concrete definition for "business-related" communication.

The Books and Records Rule provides a robust list of specific documents and materials required to be maintained but can still leave advisers unsure of the requirements as they pertain to everyday communications such as email, social media usage, or others.

For example, would you consider correspondence regarding recent market events to be “business-related”? According to a 2022 administrative proceeding, the answer could be “yes,” discussions of market analysis and events, among other similar topics, should be retained for recordkeeping purposes.

Further, the administrative proceeding identified that internal communications within your firm may still fall into their interpretation of “business-related” communications.

These considerations should highlight the critical importance of establishing proper compliance policies and procedures. PINE believes that strong and effective policies should establish approved modes of business communication, archiving and record retention procedures, personnel training, supervisory oversight.

Know the approved communications channels

Policies, procedures, and training should address the specific approved electronic communications channels of your firm, such as an employee’s firm email address and firm-sponsored communication tools such as Slack or Microsoft Teams.

Implement archiving and record retention of channels

An adviser should ensure that all approved communications channels are, in fact, retained in accordance with the Books and Records Rule.

This means speaking with your firm’s IT service provider about retention of your approved channels or potentially engaging third-party service providers to provide formal books and records retention services.

Considering that improper record retention is at the heart of the SEC’s recent sweep through the industry, a strong policy should provide examples of common communications channels that are not reasonably available for compliance recordkeeping and are thus not approved for business purposes, such as the use of personal email and personal phone text messaging.

Dedicate time to employee training

Training and discussions with employees play a critical role in ensuring you and your firm do not run afoul of the SEC as they continue their sweep across the industry for off-channel communications violations.

The increasing use of third-party messaging applications such as WhatsApp highlights the importance of clear and well-thought-out policies. Firms may approve any message applications for business purposes as they see fit, but only once procedures for retention and review of communications on these channels are in place.

Since channels may vary significantly from one firm to the next, training employees on the policies and procedures regularly will provide a sense of confidence for both the employees and the firm.

Continue monitoring and oversight

Firms should be aware of potential bad practices regarding their off-channel communications. Evaluation of communications is essential to understanding the ways in which employees converse internally and externally to clients.

Certain logistical or administrative communications such as texting “I am running late” may be OK and not considered “business-related” communications, however, a high number of these communications by a single employee may be establishing a habit or open a line for potential communications in the future that your compliance team may be concerned with.

IV. New Reporting Requirement for Small Business Owners

In an attempt to combat money laundering and financing terrorists, the Corporate Transparency Act is requiring small businesses to file a Beneficial Ownership Information (BOI) with the U.S. Department of Treasury’s Financial Crimes Enforcement Network (FinCEN), effective this year.

FinCEN has taken the first step to educate Small Business owners on the reporting requirements by posting the compliance guide on its website.

Other than the 23 exempted entities (listed in the compliance guide), there are eligibility requirements for national and international companies equally. Failure to report will result in civil penalties of $500 for each day of violation. In addition to criminal penalties of $10,000 or up to two years of incarceration.

An Eligible Domestic Reporting Company is a corporation that is formed as a Limited Liability Company (LLC). A Foreign Reporting Company is also eligible if it’s registered to do business in the United States and is doing filings with the Secretary of State.

Below are the deadlines for Reporting Companies created/registered to do business:

1. before January 1, 2024, will have until January 1, 2025
2. on or after January 1, 2024, and before January 1, 2025, will have 90 calendar days after receiving notice of the company’s creation or registration
3. on or after January 1, 2025, will have 30 calendar days from actual or public notice that the company’s creation or registration

The Northern District Court of Alabama ruled the CTA as “Unconstitutional”, as it goes beyond Congress’ powers. FinCEN complied with the ruling by excluding the plaintiff, the National Small Business Association, from filing.

Unless a class action lawsuit follows the Alabama District injunction, the summer of 2024 is the time for small businesses to learn about the BOI reporting eligibility and requirements. As well as being acquainted with the terms available in the form such as Direct filer, directs or controls the filing action, and beneficial Owners which is driven by either Substantial Control or Ownership Interest.

Justin, Parks (son), Sara (wife), & Lillian (daughter)

Justin Long - ACSS Director

PINE is excited to welcome Justin as our Director for Advisor Compliance Suppport Services! Justin brings years of experience and expertise to the team!

Education - JD from Elon University School of Law, BA in Political Science from the University of Alabama.

Prior Experience - Almost 10 years in the industry starting with NASDAQ on the corporate governance team, followed by compliance consulting with Fairview, and most recently Chief Compliance Officer of Potomac Fund Management.

Get to Know Justin!

We asked Justin a few questions to hopefully give our readers some insight into his background and personality.

1. Why did you join PINE?

The culture and the ability to collaborate with a small group of compliance experts to share my experience and knowledge.

2. What is your favorite movie?

Goodfellas

3. What are some of your favorite weekend activities?

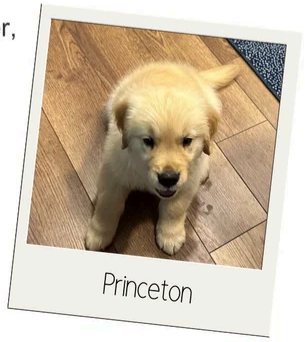
Spending time with family, quail hunting with my dog in the Fall-Winter, and yard work.

4. What is something you recommend everyone do or try at least once?

Fly Fishing - It's extremely challenging, but the reward at the end of the hook is so fulfilling!

5. One last thing Justin would like to share:

In Q2, I hired an intern to support the team. Meet Princeton!



Princeton

Brain Teaser Answer 💡

The answer is 22.

The clock hands overlap at: 12:00, 1:05, 2:10, 3:15, 4:20, 5:25, 6:30, 7:35, 8:40, 9:45, and 10:50 twice a day (AM and PM). There's no overlap at 11:55 because the hour hand is moving closer toward 12 when the minute hand is at 11.

Get in Touch

Empowering Growth, Guiding Success

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